STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities	:	
	:	
Proposed General Increase in Gas Rates	:	Docket No. 14-0371

COMPANY REPLY BRIEF ON EXCEPTIONS

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I. INTRODUCTION

The Company agrees that technical exceptions 1, 2 and 3 proposed by Staff in its brief on exceptions are appropriate. The Company does not object to Staff's proposed technical exception 4. Accordingly, this reply brief on exceptions addresses only the cost of common equity issue (item IV. B. 2. of the agreed outline of issues in this case) to which both of Staff's proposed exceptions relate.

The Commission should reject both of Staff's exceptions. The Proposed Order's calculation of the cost of common equity is fully supported by the record in this case, and is consistent with Commission precedent.

II. SECTION IV.B.2 COST OF COMMON EQUITY

A. Response to Staff Exception #1

Staff suggests changes to the Proposed Order's discussion of the effect of Mr. Hevert's calculation of Alternative CAPM models.[1] These changes are not necessary. The Proposed Order accurately discusses Mr. Hevert's alternate CAPM. As the Company's Reply Brief noted, Mr. Hevert did not make specific adjustments to his ROE range or recommendation based on the alternate CAPM analyses (meaning the alternate CAPM analyses are only tertiary confirmations of Mr. Hevert's independently supported conclusions).[2]

B. Response to Staff Exception #2

Staff's brief on exceptions argues that the Proposed Order incorrectly determined the cost of common equity and authorized rate of return.[3] Staff is incorrect. The

[1] *See* Staff Brief on Exceptions at 5-6.
[2] Company Reply Brief at 38. *See also* Company Brief on Exceptions at 18.
[3] *See* Staff Brief on Exceptions at 6-11.

Proposed Order correctly determined the cost of common equity and authorized rate of return in a manner consistent with Commission precedent and the facts of this proceeding. Staff's brief on exceptions repeats arguments it already made—arguments that the Proposed Order already considered and reflected in its determination of the cost of equity in accordance with Commission precedent.

DCF

a. The Company's DCF Model was Reasonable and was Appropriately Included in the Proposed Order's Averaging Approach

Staff claims that the Proposed Order erred by including Mr. Hevert's DCF results despite sharing the concerns expressed by Staff in this docket and in Docket 13-0192 with respect to Mr. Hevert's growth rate in the final stage of his DCF Model.[4] Staff fails to mention that in Docket 13-0192, which involved the same issue with Mr. Hevert's DCF analysis that Staff raises in this proceeding, the Commission determined it was appropriate to include Mr. Hevert's DCF.[5] Staff's approach would go against recent, directly applicable Commission precedent on this issue.

In addition, the Company has demonstrated in this proceeding that Mr. Hevert's model is reasonable, including in response to the criticisms Staff raises (again) in its brief on exceptions. Staff's criticisms in its brief on exceptions primarily focus on the growth rate used by Mr. Hevert.[6] The growth rate used by Mr. Hevert is consistent with industry literature indicating that long-term historical real GDP growth is a proper

[4] *See* Staff Brief on Exceptions at 6-7.
[5] *See Ameren Ill. Co.*, Docket 13-0192 at 163 (finding the DCF recommendations of each party to be of sufficient value).
[6] Staff Brief on Exceptions at 8.

estimate of expected long-term real growth.[7] Morningstar, a source cited by Staff, notes that "[g]rowth in real GDP (with only a few exceptions) has been reasonably stable over time; therefore, its historical performance is a good estimate of expected long-term (future) performance."[8] In fact, Morningstar's long-term estimate of real GDP growth (3.22 percent) is within five basis points of the 3.27 percent growth rate assumed in Mr. Hevert's Multi-Stage DCF analyses.[9]

Additionally, Mr. Hevert pointed out that there is academic support for his approach and long-term expected growth rate: "Expected growth rates vary somewhat among companies, but dividend growth for most mature firms is generally expected to continue in the future at about the same rate as nominal gross domestic product (real GDP plus inflation). On that basis, one might expect the dividends of an average, or "normal," company to growth at a rate of 5 percent to 8 percent a year."[10]

Staff criticizes the Proposed Order for accepting the Company's DCF results because it claims the results rely on an unsustainable growth rate.[11] Staff claims the Company's 5.72 percent terminal growth rate means the gas sample company's would have to indefinitely sustain an average of 18.72% return on new common equity investment.[12] However, Staff's argument is based on the simple "b times r" formula it proposes, rather than the more sophisticated model on which Mr. Hevert relies. The Company's reply brief showed that the simple "b times r" formula used by Staff has not,

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[7] Company Ex. 10.0 at 26:506–28:534.
[8] Company Ex. 10.0 at 27:521-524.
[9] Company Ex. 10.0 at 27:519-526.
[10] Company Ex. 10.0, at 28:529-29:534, citing Eugene Brigham and Michael Ehrhardt, Financial Management: Theory and Practice, 12th Ed. (Mason, OH: South-Western Cengage Learning, 2008), at 291.
[11] Staff Brief on Exceptions at 7.
[12] *Id.*

in fact, been a limiting factor for gas utilities' historical growth.[13] Staff's brief on exceptions adds nothing new. Staff's objection is not so much a criticism of Mr. Hevert's analysis as it is an indication that Staff's DCF model is flawed.

b. Staff's DCF Model Contained Downward Bias

Staff claims the Proposed Order does not identify any concerns or shortcomings regarding Staff's DCF analysis.[14] The Proposed Order, however, states that "the Commission does not endorse every input to the DCF analyses, or rationale therefore, presented by the Company *or Staff*."[15] The Proposed Order notes the Company's position that it has identified inputs of Staff's DCF that result in downward bias.[16] For example, the Company demonstrated that Staff's removal of the "sv" component of the Retention Growth model is not appropriate.[17] Staff incorrectly asserted that none of the Value Line sample companies will issue shares at the market price, when in actuality six of the nine companies in Mr. Hevert's group are expected to issue shares of common stock between 2015 and 2019, and that the expected market price is greater than the book value for all nine companies.[18] Staff never addressed these shortcomings in its case, or in its brief on exceptions.

Additionally, Staff's DCF model introduces downward bias by assuming that the long-term industry payout ratio should be based on the level projected by Value Line for

[13] Using Staff's logic, the average growth and earnings of South Jersey Industries, Piedmont Natural Gas, and Southwest Gas Corp. would have respectively required 18.09 , 16.39, and 18.21 percent earned ROE using the simple "b times r" model. *See* Company Reply Brief at 30.
[14] Staff Brief on Exceptions at 7.
[15] Proposed Order at 67 (emphasis added).
[16] See Proposed Order at 46-49.
[17] *See* Company Reply Brief at 27-28.
[18] *See* Company Reply Brief at 27-28; Company Schedule 7.2; Staff Initial Brief at 30(citing Staff Ex. 3.0 at 12).

the years 2016 to 2018.[19] Staff's assumed payout ratios are well below the long-term industry average of 68.85 percent and are predicated on elevated levels of capital expenditures that the industry, including the proxy companies, face through the 2016 – 2018 period persisting in perpetuity.[20] Payout ratios would be expected to increase as the capital investment cycle declines.[21] Instead, Staff assumes that the proxy companies' payout ratios will remain at the level projected by Value Line for the years 2016 to 2018.[22] This is directly contradicted by Value Line projections that seven of the nine proxy companies will experience elevated capital investments during that time.[23]

Staff's claim that its model has no downward bias ignores the significant (and generally un-answered) criticisms raised by the Company during the course of this proceeding. Consistent with precedent, the Proposed Order properly recognizes that Staff's DCF analysis is not the only reasonable approach to estimating the cost of equity.

c. Staff Incorrectly Asserts that the Proposed Order Incentivizes Upward Bias

Staff claims that blending the Company's DCF result in this proceeding would provide utilities with "additional incentive" to present upwardly biased results in the future.[24] Staff's concern is misplaced. The Commission has shown a willingness to

[19] Company Reply Brief at 32.
[20] Company Ex,7.0, Schedule 7.1.
[21] Company Ex. 10.0 at 23:442-451, citing SNL Energy, *Financial Focus, Capital Expenditure Update*, May 31, 2013, at 1.
[22] Staff Initial Brief at 24.
[23] Staff Cross Ex. 7.
[24] Staff Brief on Exceptions at 8.

completely exclude results that contain significant defects.[25] Parties that attempt to game the system by including unreasonably biased results can expect to have no weight given to those results. Staff's criticism applies equally to its own DCF analysis—which contain questionable assumptions that bias its calculations downward—and its insistence that the Commission reflect only Staff's approach.[26] All parties should be reluctant to introduce unreasonable methodologies and assumptions lest the Commission exclude their analyses altogether.

The record in this proceeding indicates that Mr. Hevert has adapted his analytical approach to reflect certain preferences the Commission expressed in previous dockets in which he has presented testimony.[27] Examples include:

- Mr. Hevert's reliance on DCF and CAPM models in recognition of the Commission's reliance on those models;[28]
- Mr. Hevert's use of a DCF that relied only on 30-day averaging periods for stock prices to reflect the Commission's preference for more recent data;[29]
- Mr. Hevert's development of his primary CAPM analyses to reflect the Commission's stated preference for betas calculated over five years, and for Market Risk Premia ("*MRP*") calculated using only dividend-paying companies. [30]

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[25] *See Ameren Ill. Co.,* Docket 13-0192 at 164-65 (Order, Dec. 18, 2013) (excluding results containing significant defects).
[26] *See* discussion *supra* at 4-5.
[27] Company Ex. 4.0 at 3:61-63, 14:258-262, 26:479-27:485.
[28] Company Ex. 4.0 at 7:119-122.
[29] Company Ex. 4.0 at 20:363-21:368. Mr. Hevert stated that his general practice is to consider 30-day, 90-day and 180-day average stock prices. *Id.*
[30] Company Ex. 4.0 at 26:479-27:485.

The Commission should reject Staff's exception to the Proposed Order because the Proposed Order's approach follows Commission precedent on this issue and reflects the record in this case.

CAPM

Staff complains that the Proposed Order errs by averaging together the Company's primary CAPM results with Staff's CAPM results because it gives more weight to the two Beta estimates that are in common between the two analyses.[31] However, it is only logical to give more weight to the two Beta estimates that both the Company and Staff agree are appropriate. Discounting data points that the parties use in common would introduce a bias towards more controversial data points.

The Commission should understand that Staff incorrectly refers to the Bloomberg-sourced beta used in Staff's analysis as being a Bloomberg "published" beta.[32] Bloomberg did not publish this beta. Rather, Staff's "Bloomberg" beta is a modification to Bloomberg's beta that reflects Staff-specified parameters set forth in Staff data request RMP 1.03.[33] The standard Bloomberg betas are provided in Mr. Hevert's alternate CAPM analyses and average 0.78.[34] This is substantially higher than the 0.62 average reported in Staff's reply BOE.[35] In fact, Bloomberg's average default beta of 0.78 is higher than the entire range of the Beta coefficients presented in Table

[31] *See* Staff Brief on Exceptions at 8-10.
[32] *See* Staff Brief on Exceptions at 9.
[33] *See* Staff Ex. 3.0 at footnote 44 ("the five-year Bloomberg beta estimate was provided by Mr. Hevert. Co. Resp. to Staff DR RMP 1.03").
[34] *See* Company Schedule 7.7.
[35] *See* Staff Brief on Exceptions at 9, Table One: Beta Summary.

One of Staff's reply BOE 0.62 to 0.73.[36] Staff's claim that the betas it used in this portion of its CAPM analysis are Bloomberg "published" is incorrect.

In addition, there are other differences in the Company's and Staff's CAPM analyses, including the timing of the data used and the data sources relied on to calculate the MRP.[37] Consequently, the overlap in the assumptions of one component of Staff's and Mr. Hevert's CAPM models is not a sufficient reason to exclude the results of the Company's analysis on the basis claimed by Staff.

Staff argues that Mr. Hevert's MRP estimates reflect an inflated market return.[38] Staff claims that certain individual companies in Mr. Hevert's market return calculation have relatively high growth rates.[39] However, Mr. Hevert explained that it is entirely reasonable for a broad market index such as the S&P 500 to contain companies with relatively high and relatively low growth rates at any given time.[40] In fact, Mr. Hevert's market return included a number of companies with negative growth rates.[41] Mr. Hevert noted that the work papers provided for Staff's direct testimony show Staff relied on growth rates that ranged from negative 24.70 percent to 41.08 percent.[42] Staff also complains that growth rates were not reported by Value Line for thirty-five of the S&P

[36] *See* Company Schedule 7.7; Staff Brief on Exceptions at 9, Table One.
[37] *See* Proposed Order at 43. Staff's 9.54% CAPM estimate is based on results provided in Staff's direct testimony using data as of January 31, 2014 (See Staff Ex. 3.0 at 23, footnote 43), while Mr. Hevert's CAPM results are based on results provided in Mr. Hevert's rebuttal testimony using data as of July 31, 2014 (see Company Ex. 7.0 at 51). Staff's expected market return was calculated using growth rates provided primarily by Zacks and secondarily by Reuters (See Staff Ex. 3.0 at 24), while Mr. Hevert calculated two market return estimates using growth rates provided by Bloomberg and Value Line (see Company Ex. 7.0 at 52).
[38] Staff Brief on Exceptions at 10.
[39] Staff Brief on Exceptions at 10.
[40] Company Ex. 10.0 at 36:687-37:711.
[41] *Id.*
[42] *Id.*

500 companies.[43] Staff's argument is without merit. Staff has provided no evidence to show investors would not rely on the range of data provided by Value Line as an estimate of market return.

Staff additionally claims that the Company's MRP contains inconsistent market values and inconsistent dividend yields.[44] Staff is mistaken. This is not an "inconsistency" as Staff suggests but a reflection of the fact that market participants use different assumptions and methodologies. As Mr. Hevert pointed out Bloomberg uses intraday prices in calculating the reported market capitalization, while Value Line uses previous day's closing prices.[45] Additionally, Bloomberg's reported dividend yield is based on analysts' consensus estimate of the current calendar year dividend amount, while Value Line's reported dividend yield is based on the dividends paid over a trailing twelve-month period.[46] Understandably, there will be some difference between the values reported by Bloomberg and Value Line on a given day given these different assumptions and methodologies.[47] The fact that those services, both of which are highly reputable and relied upon by investors, apply different approaches in no way detracts from their usefulness.[48]

Finally, as it did when it argued that only its DCF should be considered in determining the cost of equity, Staff argues that the Proposed Order does not identify biases in Staff's CAPM analysis. Staff once again ignores the Proposed Order's statement that the Commission does not endorse every input to the CAPM analyses, or

[43] Staff's Brief on Exceptions at 10.
[44] Staff Brief on Exceptions at 10.
[45] Company Ex. 10.0 at 37:715-723.
[46] *Id.*
[47] *Id.*
[48] *Id.*

rationale therefore, presented by the Company *or Staff*.[49] As discussed above, the Company has addressed the concerns noted in Staff's Brief on Exceptions, and the Company's results include market data from widely used and well-respected data providers that are not reflected in Staff's analyses. Excluding the Company's results would unduly bias the cost of equity downward.

Staff's exception indicates that it is not content to have its position reflected in the Proposed Order's calculations. Rather, it believes that the Commission should only consider its approach in determining the cost of equity—despite its numerous questionable assumptions and methodologies identified by the Company. The Company submits that the Proposed Order's approach is consistent with precedent and the record in this case and should be retained.

III. CONCLUSION

Therefore, Liberty Midstates, for all the reasons set forth above, respectfully requests that the Commission enter findings and make conclusions on all issues consistent with the Company's positions.

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[49] Proposed Order at 68 (Emphasis added).

Respectfully submitted,

LIBERTY UTILITIES (MIDSTATES NATURAL GAS) CORP. d/b/a LIBERTY UTILITIES

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